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HIGHLIGHTS

IS FINANCIAL GLOBALIZATION TRULY GLOBAL?

New Institutions for an Inclusive Capital Market

PHILIP ARESTIS AND SANTONU BASU

International capital flows are touted as one of the benefits of globalization, and a great many steps have been taken over the past 30 years to make lending in foreign markets easier for banks and investors. In theory, investing across borders enables countries that lack capital, including many developing nations, to obtain the funds they need for industrialization. But while breaking down some regulatory barriers can, potentially, increase the efficiency of the world economy and spur growth, many countries cannot find buyers for their securities because of fears about the stability of their currencies. A truly globalized financial market that benefits all countries will not exist in the absence of global institutions dedicated to insuring wider access to international sources of funds.

This brief states the rationale for deregulating financial markets and points out some deep flaws in the current financial system. The authors then propose the establishment of an international monetary authority, with its own currency, as a means of completing the process of globalization on terms fair to all.

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The Fall and Rise of Globalization

At the end of World War II, various controls, including fixed exchange rates and restrictions on international flows of capital, were imposed on international finance in order to maintain financial stability. International leaders, recognizing that currency and financial markets would be vulnerable to destabilizing outflows of funds unless some regulations were in place, put limits on purchases of foreign currency and lending across borders.

Many nations also took steps to ensure that industry had access to needed capital on easy terms. In numerous cases, they capped interest rates and established specialized banks dedicated to particular industries. A number of governments guaranteed loans, or forced financial institutions to lend to companies that otherwise would not have qualified for credit. In the absence of government intervention, policymakers realized, worthy borrowers who failed to meet credit standards might not be able to obtain capital. In particular, newly developing industries might lack sufficient collateral or cash flow.

By the 1960s, many scholars and policymakers began to have second thoughts about the desirability of tight financial regulation and other government intervention in capital markets. The case for deregulation of financial markets was based on the efficiency of a free market in capital. In a deregulated market, no industry or firm would be given favorable treatment, so all would have to meet the same standards of creditworthiness and pay market interest rates. This system would ensure that capital was allocated to its most productive uses; all projects whose predicted return was greater than the rate of interest would be funded, while less profitable ventures would not be viable.

Financial deregulation would not only direct capital flows to their most productive uses, reformers argued, it would also increase total savings available in the economy (McKinnon 1973; Shaw 1973). When caps on interest rates were lifted, the incentive to save would be increased. By taking the further step of eliminating restrictions on international purchases of currency and allowing foreign banks to serve domestic borrowers, economies could also draw upon foreign sources of capital.

Around the same time that financial reform became a topic of discussion, many economists proffered a related set of arguments regarding trade balances. According to some economists, allowing the exchange rate to "float" lets nations maintain a balance of imports and exports. This mechanism was not operative as long as governments attempted to fix the value of their money by trading currency on international markets.

All of these arguments for financial and foreign exchange liberalization had an impact; country after country joined the currency-float trend and removed financial regulations of various types. But, after 30 years of reforms, the ideal of a global capital market has not yet been reached.

Problems of Financial Globalization: Instability and Differences in Access

In a world in which restrictions on international capital flows have been nearly eliminated, why do some countries, industries, and firms still have so much trouble obtaining loans? The answer lies, of course, in the risk of default. Domestic lenders cannot be assured of the complete safety of their loans, but foreign borrowers face the additional problem of having to pay interest in dollars, euros, or yen, rather than in domestic currency. Even if a project is profitable in terms of domestic currency, the possibility remains that the currency will depreciate or completely lose convertibility.

Lenders who are concerned about this sort of exchange rate risk usually demand that the borrower provide some form of collateral. In the case of foreign loans, collateral must take the form of assets that can be sold for an internationally recognized currency. Usually, only industries and countries with strong export earnings can provide such assets. Hence, firms must meet what is in essence a higher credit standard for international loans than for domestic ones.

Even when a nation is able to borrow on international financial markets, it may quickly lose access to funds if investors panic. Several of the emerging Asian economies, including those of Thailand and Malaysia, suffered greatly in 1997 when international investors began to dump assets denominated in baht and ringgit.

Proponents of capital market liberalization argue that open financial markets can stabilize economies by allowing them to borrow money in hard times and share the risk of poor economic outcomes with foreign investors. In fact, empirical evidence indicates that, under liberalization in the 1990s, a country's GDP may have stabilized, but consumption did not. The theoretical benefits of globalization do not translate into higher standards of living (Kose, Prasad, and Terrones 2003).

Toward a More Inclusive Globalization

To solve the problems of finance shortages and financial crises, less-developed nations must gain access to currency that can be used to settle debts with lending nations. One way of accomplishing this would be to create an international currency and an international monetary authority.

The new international central bank (ICB), which would amount to a kind of International Monetary Fund (IMF) with a Keynesian bent, would issue a currency for use only by central banks around the world. Like the Federal Reserve Bank, it would keep track of transactions between member banks (in this case central banks) and cancel out offsetting debits. If a particular central bank developed short-term or chronic liquidity problems (i.e., a lack of reserves needed to accommodate international transactions), the ICB would provide reserves temporarily. All transactions between central banks that adopted the new currency would be denominated in that currency.

Knowing that the ICB would help national central banks in times of distress, investors would be less skittish about rumors of an impending currency collapse. The resulting currency stability would help international borrowers retain access to the loans they needed. In order to make all of this possible and to ensure prudent lending, the ICB would have the power to monitor and supervise international capital flows. The tilted playing field of international capital markets would be somewhat leveled.

John Maynard Keynes proposed an ICB shortly after World War II.[1] Keynes's suggested international currency, the Bancor, would be "fixed (but not unalterable) in terms of gold and accepted as the equivalent of gold . . . for the purposes of settling international balances." The proposed bank "can with safety make what advances it wishes to any of its members with the assurance that the proceeds can only be transferred to the bank account of another member. Its problem is solely to see to it that its members behave themselves and that the advances made to each of them are prudent and advisable from the point of view of the Union as a whole" (Keynes 1980, 72–73).

Existing institutions could be used to implement Keynes's proposal. An ICB, as part of a revamped IMF, could issue an international clearing unit (ICU) to serve as a medium of exchange and reserve asset. The ICB would issue ICUs in return for gold, dollars, and the reserves of other member central banks. The ICB would, therefore, be a double-entry bookkeeping institution, providing overdraft services to deal with imbalances between economies. It would try to ensure that unused balances in countries' accounts could be mobilized, not hoarded. It should be committed, along with member central banks, to guaranteeing one-way convertibility of the ICU to national monies.

A sister institution to the ICB, called the International Investment Agency (IIA), should be established as a replacement for the World Bank. The IIA would have two specific aims. First, it would provide finance for investment, especially to developing and emerging economies, allowing them to industrialize without depending upon developed countries. Second, it would stand prepared to lend ICUs to countries to help them avoid currency crises.

The IIA would not only ease the straits of countries with net foreign deficits, but also encourage surplus nations to do their part to correct imbalances. This is important because, in the existing system, countries can cut their own demand for imports and create a bias toward a current account surplus by reducing growth within their own countries. They reap the benefits of export demand, while generating current account deficits in importing economies. Deficit countries then find themselves under pressure to reduce demand within their own economies in order to control their deficits. The IIA would discourage the use of this "beggar-thy-neighbor" policy by encouraging nations with large amounts of international reserves to invest those reserves in its own projects or other concerns in developing nations. The IIA would also see to it that countries that consistently ran surpluses took steps to raise domestic aggregate demand (except when income was already growing rapidly), so as to increase demand for imports. In this way, nations could cope with current account deficits without resigning themselves to crippling austerity measures.

Conclusion

Observers are correct in some sense when they describe capital markets as globalized. But the perception that barriers to foreign lending are falling masks a reality in which many nations cannot obtain needed capital, even for potentially profitable investments.

To ensure that capital markets work for the benefit of all and facilitate economic development, policymakers must create appropriate institutions and, to some extent, limit the free movement of capital and exchange rates. The creation of a world currency whose value is guaranteed by an ICB would encourage lenders to serve markets that would otherwise be cut off from the spigot of international capital. Such a bank might also prevent currency crises of the type that increasingly plague emerging economies. With the advent of these reforms, globalization might begin to live up to its promise as an engine for development and prosperity.

Note

1. For a similar proposal, see Davidson (2003). In a proposal to reform the global financial system, Stiglitz (2002) argues for substantial changes to the IMF, World Bank, and World Trade Organization.

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